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Rare Headwinds Toss India's Outsourcers

By ELLIOT WILSON

Emerging Markets[1]

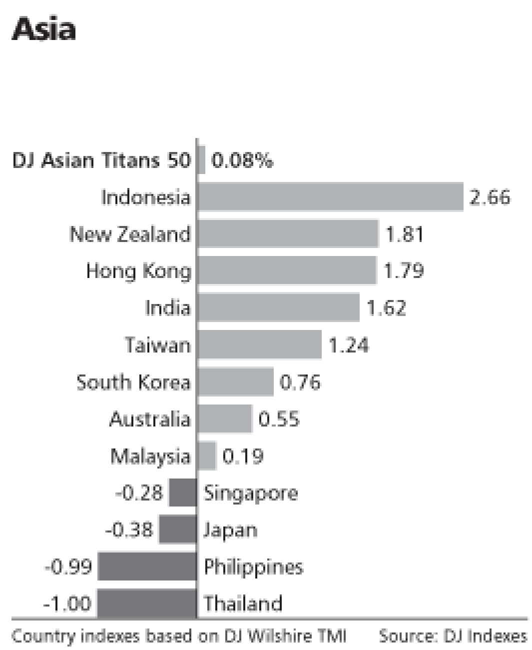
INDIA'S SUMMER MONSOONS have brought not just rain this year but tricky winds and unusual turbulence for the country's information-technology companies.

The cause is India's currency, the rupee. Once one of the most enfeebled currencies in Asia, it has been on a tear in recent months, appreciating by an unprecedented 7.1% in the second quarter alone.

"The key issue for the entire sector in the near term is not the business environment -- underlying demand and price trends are encouraging -- but the margin pressure stemming from currency appreciation," says Ashish Thadhani, senior vice president for research at New York-based Gilford Securities.

The rising rupee is dampening earnings at India's leading tech companies, most of which derive more than half their sales from clients in the U.S. As a result, Nasdaq-listed **Infosys** (ticker: INFY) and Mumbai-listed Tata Consultancy Services, or TCS (TCS.India), saw around five cents swept off diluted earnings per American depositary share for the first quarter of fiscal 2008, which for India's companies began April 1.

A further drag on industry leaders is surging salaries -- a worrying new phenomenon caused, perhaps inevitably, by the increasing size, wealth and power of India's tech sector, which allows skilled engineers to jump easily to higher-paying jobs across town.



Mixed Showing: Japanese shares edged lower last week, but stocks in Hong Kong rose.

"There is a fierce war going on between IT companies to retain employees," says Christopher Palmer, head of global emerging markets at Gartmore Investment Management in London. "Wages and benefits have gone up, and it's becoming normal to see very strong double-digit wage increases."

Both factors have hit stock prices.

Shares of Infosys, **Syntel** (SYNT), **Wipro** (WIT) and **Cognizant Technology Solutions** (CTSH) have lost between 5% and 12% of their value over the past three months, even as the Nasdaq gained nearly 8%. Only NYSE-listed **Satyam Computer Services** (SAY) has bucked the headwind -- its stock is up almost 10% in that time thanks to a concerted effort to hire cheaper college grads and keep costs down.

TCS' chief financial officer, S. Mahalingam, conceded to *Barron's* that currency and salary increases had made the first quarter "a bit of a challenge."

Nonetheless, the basic themes in India's remarkable recent run haven't been shaken. The country's top technology companies are among the most aggressive in the world, keeping costs low, reinvesting heavily and continually pushing into non-U.S. markets. TCS in the most recent quarter set up a development center in Mexico, catering to 150 clients across 14 countries in Latin America.

And despite the robust rupee's fiscal-first-quarter toll, the broader earnings outlook remains bright. Infosys posted diluted earnings of 46 cents a depositary share in the quarter, compared with 31 cents a year ago. Gilford Securities has raised its estimates for fiscal 2008 to diluted earnings of $1.95 on revenue of $4.187 billion, from $1.85 on revenues of $4.165 billion. TCS posted a 37.4% year-on-year rise in first-quarter earnings, to $292 million, on revenues of $1.289 billion, and most analysts maintain a Buy rating on the stock.

David Riedel, managing director of New York's Riedel Research, sees India's IT industry, which recorded sales of $47.8 billion in calendar year 2006, continuing to grow at just shy of 30% a year for the foreseeable future.

Yet the currency issue has introduced some uncertainty. Some analysts believe the rupee will depreciate in the near term; others worry that India's central bank will soften its policy of currency intervention, pushing the rupee below the psychological barrier of 40 to the dollar.

This situation has encouraged analysts to think more broadly about India's IT sector. Riedel highlights a pair of Mumbai-listed stocks -- KPIT Cummins (KPIT.India) and Tech Mahindra (TECHM.India), niche software providers to the auto and telecom sectors, respectively -- as less sensitive to the currency, and focused on opportunities beyond financial services outsourcing.

Thadhani likes Cognizant, a $12 billion-global company that, despite its Teaneck, N.J., headquarters, is India's fourth-largest software exporter. Nasdaq-listed Cognizant, he says, will outpace its rivals, growing at a compound rate of 35%-40% in 2006-2008, versus 25%-30% for its peers. And he says a recent drive to cut head count and costs was misinterpreted by the market as a sign of weakness, leaving the shares due for a bounce -- Thadhani has a $108 target on a stock that closed at $84.99 on July 19.

He remains bullish on the sector: "Currency is the overriding near-term issue -- it's going to be choppy trading for a while, but that may create opportunities for investors."

ELLIOT WILSON, a freelance writer who's lived in Beijing and Hong Kong, will soon cover Indian markets from Mumbai.

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